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Commentary on Pertinent Economic Issues

For Boom The Bell Tolls

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For about three years, economists have been scanning the business horizon, waiting for the next recession to come into view. Summer 1987 saw the recession watch begin because the expansion, which was born at the end of 1982, was approaching the previous record for peacetime longevity, and was beginning to show signs of old age. Inflation was picking up, interest rates were climbing, sales of autos and housing were softening, and, of course, the stock market peaked in late August—and crashed in October.

The 26 percent plunge in stock prices in mid-October 1987 brought many forecasters into the recession camp. This is because the only time in this century when a drop in stock prices of this magnitude was *not* followed by a recession was just at the start of World War II. Then, the military buildup more than offset the depressing effects on wealth and confidence that might have arisen from an even greater plunge in stocks. Since we were not on a wartime footing in 1987, it was not unreasonable to expect the negative effects of the market's fall to ripple out, producing the nation's ninth postwar recession.

Today's Troubles Began in 1987

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Obviously, there was no downturn, economy-wide. However, the *beginnings* of one did get underway, which was masked by the sharp drop in interest rates and in many commodities' prices, the quick rebound in stocks, and the surge in exports thanks to the earlier decline in the value of the dollar compared with the currencies of our major trading partners. Nationwide, there was a drop in consumer spending, which led to a decline in output and in goods-producing jobs. New-home purchases were postponed, while business outlays for physical plant dropped to levels first seen in late 1973.

But it was localized developments that were to prove fatal for the aging expansion. Not that different regions hadn't taken hits earlier, without dragging the entire economy down. The Southeast suffered early in the expansion because the Latin American debt crisis, with its attendant currency devaluations hurt foreign buying power. The Farm Belt experienced a couple of bad weather years, while the Oil Patch took its lumps as the price of oil plummeted in late 1985-early 1986. And the Midwest saw its market for heavy industrial goods like steel and automobiles melt away to changes in technology, as well as to foreign competition.

Because these regions did not decline simultaneously, the national expansion rolled on. However, the decline in stocks in October 1987 led to something broader. First, there was reduced trading activity, hence, drops in brokerage houses' and brokers' incomes. Financial industry employment was also affected by the reserving actions taken by the money-center banks that summer because of their developing country debts. The wave of leveraged buyouts led to widespread staff cuts—both among those companies directly involved, as well as by others, seeing an opportunity to slim down. The decline of the junk bond market and tight money slowed the takeover boom, causing many investment bankers to lose their jobs as well.

Blame It On Real Estate

These cuts in the ranks of top professionals, managers and their clerical support staff, had the effect of reducing the demand for office and residential space just as changes in local zoning codes and anticipation of the Tax Reform Act of 1986 had caused builders to hasten the development of many properties. The result was a decided softening of the real estate market, which, although starting in the Northeast, quickly spread across the country. Not only did this slow the construction business—the nation's largest industry—it also began to have a powerful affect on people's attitudes. For unlike stocks, which are owned by only a minority of people, real estate is—literally—closer to home. And the ensuing drop in housing prices, moreso than the plunge in stock prices, convinced people that hard times were at hand.

Not surprisingly, consumers' confidence levels started to erode around two years ago, which, of course, was the major reason for the pullback in spending. They took a header this past August, in response to the jump in oil prices brought on by Iraq's invasion of Kuwait. Business, seeing the sharp drop in retail sales, responded by slashing output and by laying off workers, although not fast enough to prevent

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an unwanted pileup of unsold goods, which, of course, will have to be worked down. New-home construction continued to decline, hitting eight-year lows, with no end in sight, while even exports, until now the bright spot, declined over the summer as Canada, our biggest trading partner, edged toward recession.

In trying to assess whether our own recession has already begun, keep in mind the following:

- Five of the eight postwar recessions started with the real gross national product rising during the opening quarter, so we could well have entered into the ninth as far back as this past spring, when actual sales to final consumers fell for the first time in eight years.

- There need not necessarily be two consecutive quarterly declines in real GNP for a recession to be declared, since two of the eight lacked this "requirement."

No Policy Ease So Far

As far as determining how bad this downturn will be, a look at the posture of economic policy alone suggests it might be worse than average. This is because, for the first time since the 1930s, both fiscal and monetary policies are not easing to cushion the downturn. True, Washington's budget deficit is large. It is approaching a record in absolute terms, and will likely be the greatest, relative to the size of the economy, since 1986. However, the emphasis nowadays is not to ease, which would involve widening the deficit by spending more and/or by taxing less, but, rather, just the opposite! Gramm-Rudman, the Federal Reserve, and the prevailing view in the economics profession all say that Washington's deficit must be reduced, in order to relieve pressures on the financial markets so that interest rates might come down. For its part, monetary policy remains relatively tight—even though a recession might well have gotten underway nearly a half year ago—as Fed Chairman Alan Greenspan remains concerned about the lack of a budget agreement, not to mention today's high rate of inflation.

On the fiscal side, this Report has, for years, been calling for deficit reduction, so it may come as a surprise to the reader that, at this time, caution should be the watchword. From here, it would appear that we lost the opportunity to make major cuts in Washington's deficit when the expansion fizzled out. Now that the economy is declining, to make wholesale cuts in the deficit by either cutting spending and/or by raising taxes would only push the economy down even more.

Under these circumstances, lower interest rates, whether fostered by the Fed or by the markets, themselves, might not be of much help. As we learned during the 1930s, easier money does not by itself boost economic activity. As the economy spiraled downward into what came to be known as the Great Depression, the Fed flooded the banking system with reserves, hoping to drop interest rates down low enough to stimulate the borrowing necessary to increase spending. Rates came down all right, but the banks refused to lend and people were reluctant to borrow. This gave rise to the expression, "You can't push on a string."

In some respects, we are in the same circumstances today. The deflation of many asset values, such as real estate, along with huge debt loads now being borne by consumers and corporations and the contraction of the junk bond market, has begun to affect attitudes toward debt on the part of both borrowers as well as lenders. Total consumer debt outstanding now equals a record 85 percent of take-home pay, while America's nonfinancial corporations must now set aside more than 35 cents out of every cash flow dollar just to service existing debt—nearly twice the level of five years ago.

Lenders, naturally, have become more reluctant to extend credit. Many banks and thrifts have experienced significant increases in problem loans, while others are being told by their regulators to boost their capital ratios. Both have led in the same direction: lending cutbacks, often referred to as a credit crunch.

Not that the Fed appears to be in any great hurry to ease. Even though the Federal funds rate has come down a point over the past year, most money and credit aggregates still show little growth. Besides waiting for a credible budget agreement, Fed Chairman Greenspan is also waiting for inflation to subside. He may have a long wait. Besides the price of oil, inflation is also being pushed up by services such as medical care and education, over which monetary policy has little, if any, control (Economic Report—August 1990). Most nonenergy goods' prices are rising only slowly.

The Fed also seems to be taking its cues from the bond markets. When the funds rate was dropped slightly in July, bond yields went up, as fixed-income investors became concerned that

the Fed was "caving in" to inflation. Since then, Fed officials have referred to the possible reaction by the bond crowd to monetary and other developments. This is too bad, since the markets need to take their direction *from* the central bank, not the other way around. Anyway, bonds will be under pressure for some time to come because of the huge borrowing needs Washington will have regardless of how the deficit reduction talks are resolved, not to mention reduced purchases of Treasury securities by investors from overseas.

Having said this, it would not be good from the economy's long-term perspective if the Administration and the Congress were to use the current economic downturn as an excuse to abandon the deficit reduction process altogether. There is no question but that the economy's long-run state of health requires a closer matching of revenues with spending, and a reduction in Washington's outstanding debt—at least relative to the size of the economy. However, in today's context, the deficit reductions should be concentrated in the "out" years, or years beyond fiscal year 1991 which began October 1, rather than in the near term. A sliding scale of deficit cuts once the economy strengthens would seem to be a better way of reaching the President's goal of cutting $500 billion over five years than simply taking the same amount out of each year.

Some Bright Spots

To be sure, all is not bleak—economic policy notwithstanding. For one thing, consumers' attitudes may brighten when they see that their worst fears may not be realized. It would appear that confidence plunged in August because people have vivid memories of what happened twice before, when a Mideast crisis boosted oil prices. Not only was there a flareup in inflation along with soaring interest rates and a subsequent recession—there were also long lines at the gasoline pumps. This last development is unlikely to occur this time around because the government is out of the picture. There are no longer any Federal controls on oil and gas prices, nor is Washington telling the oil companies where to ship their products.

Inflation is unlikely to worsen beyond a brief blip for a month or two as happened last winter, when extremely cold weather caused demand for heating oil and natural gas to soar, and with it, their prices. First, the economy is too weak to allow business and consumers to pass these costs along. Second, money is tight, meaning that there isn't enough liquidity to support a generalized round of price hikes.

Then there's energy efficiency. Transportation, the biggest user of oil, has become significantly more efficient. The average passenger car on the road today gets over 21 miles per gallon—a 60 percent improvement from when the first oil crisis struck. Electric utilities, which require a growing share of the energy used in this country, now derive less than five percent of it from oil, compared with four times as much 17 years ago.

We're unlikely to catch the inflation virus from abroad, either. Other Western countries are even more energy efficient than we are—and their currencies have risen against the dollar so they won't have to pay much more for oil, which is sold for dollars. Another moderating influence on the recession might well be the after-effects of the Mideast crisis, itself. For one thing, defense outlays might not be cut as much as planned, giving a lift to those parts of the country and those industries that depend on military spending. This will create new jobs besides these made available by the callup of the reservists.

Then there's the impact of the jump in petroleum prices. When oil was priced in the mid-teens, the industry found it uneconomical to drill for more. Now that it has reached into the upper 30s, it has become much more worthwhile to search for oil on land, offshore, and from such sources as tar sands and shale. Look for intensified efforts to find and use oil substitutes for transportation, as well as for generating light, heat and energy to turn the wheels of industry. Coal, geothermal, nuclear and solar power are some of the methods that will attract investment capital, thus becoming a prop under economic activity.

Of course, the need to conserve energy will add to business as well. Expect increased efforts to use computers to design buildings and automobiles, meter out gasoline, turn on and off lights and run machinery more efficiently. Anticipate, also, that demand for insulation, storm windows, and other energy-saving devices will increase. Indeed, the business of finding and saving energy will once again move to the forefront of top-performing industries. When added to public construction, waste management and health care, you can see the potential for keeping this recession's economic damage to a minimum.

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